Quarterly Commentary

M&G Investments

M&G Income Fund

Income

Q1 2023

Market overview

So far in 2023, global financial markets have experienced wild swings – particularly in the normally less volatile fixed income markets – dictated by the guessing game over the path of US interest rates, inflation and growth.

January's sentiment was relatively bullish, dominated by expectations of a weaker US economy going into 2023, which would have increased the likelihood of softer inflation, lower-than-expected interest rates and a relatively imminent pause to the US Federal Reserve's rate hiking cycle. This was all up ended in February by surprisingly strong economic data, including more widely embedded inflation than previously thought. With the Fed signalling its intention to continue hiking, this sent market uncertainty higher and global asset prices lower, an environment that continued well into March.

Then the emergence of banking sector turmoil sparked by the sudden failure of specialist Silicon Valley Bank and the engineered buyout of Swiss banking giant Credit Suisse by UBS shocked markets even further, with swift central bank and government interventions preventing contagion to other sectors.

Gold benefited and risk-off sentiment prevailed as global financial stocks sold off.

Central banks suddenly had an even tougher policy balancing act, having to choose between their duties of fighting inflation, safeguarding national banking systems and supporting growth and employment. Ironically, this led back to more positive expectations of lower interest rates and sooner-than-expected rate pauses.

The US Fed hiked by a measured 25bps in March, as expected, as did the Bank of England (BOE), while the European Central Bank (ECB) and SA Reserve Bank (SARB) announced relatively robust 50bp increases given their higher inflation threats.

Looking back, investment managers have rarely seen such sharp changes in market views in such a short period of time. US Treasury bonds, for example, experienced high volatility of around 10%, with the 10-year UST yield falling by 50bps from around 4.0% to 3.5% between February and March – an exceptionally big move in that market.

Global bonds also posted meaningful gains: the Bloomberg Global Aggregate Bond Index delivered 3.0% (in US$). For the quarter, SA nominal bonds (the FTSE/JSE All Bond Index) delivered 3.4% in rands, while inflation-linked bonds (ILBs) produced 0.9% and cash returned 1.7%.

Credit trends

Total credit issuance volume (excluding government issuances) in Q1 2023 was very healthy at around R52bn. Issuance was buoyed by R15.8bn in tap issuance by Eskom over the quarter. Q1 issuance volume was thus 7% up compared to the previous quarter (Q4 2022) of around R49bn, and 98% up compared to the prior year (Q1 2022) at R26bn. Rolling 12-month issuance to Q1 2023 sits at R167bn compared to the 12 months to Q1 2022 of 120bn. It is noteworthy that 25% of the way through the year gross issuance is already just over 40% of the full year estimates for issuance as compiled by RMB Credit Research – a good start to the year.

The make-up of issuance for the quarter followed established trends - the majority of issuance being floating-rate notes, with auctions being the predominant placement method. Financials were the largest sector for issuance with approximately 40% of total issuance. Some 72% of the volume in the Financials sector was in the form of senior bank issuance. Data compiled by ABSA's Credit Research team indicates that, at 31 March 2023, 48% of SA listed credit is comprised of bank exposures.

After the Eskom issuance the next largest issuers were the big 5 SA banks who combined raised R17,5bn in the quarter. Firstrand Bank Limited was the largest contributor, raising R5.5bn, with R2.3bn being in the form of tier II subordinated debt, which priced at 3 month JIBAR + 1.9%. There were no new corporate issuers in the debt capital market in the first quarter.

Credit spreads moved tighter over the first quarter of the year. Floating rate spreads moved lower by 5 basis points (bps) versus Q4 2022, with fixed rate spreads closing the quarter -15 bps down.

Internationally, bank subordinated Additional Tier 1 (AT1) credit spreads were impacted by the collapse and subsequent sale of Credit Suisse to UBS. Against expectations subordinated Additional Tier 1 bonds were written off in the transaction brokered by Swiss regulators, whilst equity holders received $3.2bn. European regulators later came out to restore confidence to AT1 investors stating that the normal capital structure hierarchy (with AT1 bonds ranking ahead of equity) would be respected in any bank intervention under their jurisdiction. Locally these events have appeared to have little impact on the pricing of South African AT1 bonds.

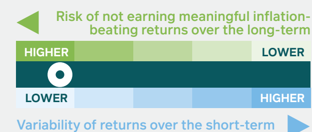
Data from RMB Credit Research shows banks continue to be active participants as a buyer of corporate credit in auctions, competing alongside asset managers. In Q1 banks received 39% of final allocations compared to an average of 29% for 2022. Interestingly, the 39% of allocations received is indicative of SA banks pricing tighter in auctions than institutional fund managers, as banks only made up 20% of the bids in theses auctions.

Performance

Over the quarter the fund delivered a return of 2.3% (A class, net of fees) compared to the benchmark's 1.7%. Because the instruments held by the fund are predominantly floating rate in nature, absolute returns achieved continue to improve as the repo rate moves higher.

Annualised performance	A class	Benchmark	D class
1 year	7.6%	6.0%	7.8%
2 years	6.3%	4.9%	6.4%
3 years	5.8%	4.8%	6.0%
5 years	6.7%	5.8%	6.9%
Since inception	7.1%	6.1%	-

Risk profile



Fund facts

Fund managers
Roshen Harry
René Prinsloo

ASISA category
South African - Interest Bearing - Short Term

Benchmark
STeFI Composite Index measured over a rolling 12-month period

Inception date
6 December 2016

Fund size
R591 708 541

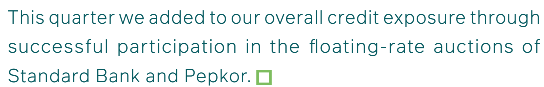
Sources: M&G Investments, Morningstar & Deutsche Securities

M&G Investments

Strategy and Positioning

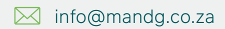
Following the bond market's strong start to the year, we took the opportunity over the past quarter to reduce duration across most of our fixed income products. Although South African bonds still appear attractive on most measures, the asset class is slowly nearing fair value. Cash is also becoming relatively more attractive, thanks to continued hiking by the SARB. Furthermore, we have concerns that continued loadshedding will negatively affect growth, which could ultimately lead to a weaker fiscal trajectory. We are already seeing signs of this happening. February's budget saw the first meaningful increase in National Treasury's debt-to-GDP projections since the 2020 MTBPS, resulting from the additional government support offered to Eskom.

In the Income Fund specifically, we more than halved duration, from 180 days at the beginning of the quarter to 77 days at quarter-end. Most of this decrease took the form of us selling out of short-dated government bonds entirely, as well as trimming the fund's I2025 position. The proceeds of these sales were invested in lower-duration floating rate instruments.



This quarter we added to our overall credit exposure through successful participation in the floating-rate auctions of Standard Bank and Pepkor.

Contact us



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